

## **MTC Staff Memo Dated July 20, 2012: “Pass-Through Entity” Project**

November 7, 2012

In July 2012, MTC staff released a 16-page report styled “Report From Drafting Group re Partnership or Pass-Through Entity Income Ultimately Realized by an Entity That is Not Subject to Income Tax” (“Staff Memo”). On the strength of the Staff Memo, the MTC’s Uniformity Committee at its July meeting again advanced its “pass-through entities” model bill (“Model”) to the MTC’s Executive Committee.<sup>1</sup>

Because the Staff Memo is based on the following material omissions, misstatements and misunderstandings, the American Council of Life Insurers, the American Insurance Association and the Property Casualty Insurers Association of America (the Trades) submit, it provides an unreliable basis on which to advance the Model:<sup>2</sup>

### **Staff Memo Pages 2 - 3**

*On June 6, 2011, the Executive Committee met by teleconference to consider the Hearing Officer’s report and recommendations regarding this proposed model statute. . . After significant public comment from insurance industry representatives and committee discussion, the Executive Committee voted to continue its deliberations. . .*

*At the July 2011 meeting, the Executive Committee heard again from insurance industry representatives. . .*

This implies that it was solely the insurance industry’s significant concerns and questions about the Model that motivated the Executive Committee’s action in the summer of 2011. In fact, similar concerns were raised by *all* third-party experts heard by the MTC with respect to the Model, including the National Association of Insurance Commissioners (NAIC), Professor Richard Pomp, as well as the leading national trade associations of the life and property and casualty insurance industries.

### **Staff Memo Page 4**

*The discussion in this memo reflects the views of the drafting group expressed during the drafting group meetings.*

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<sup>1</sup> At its July 2012 meeting, the Uniformity Committee first decided (without objection) that the Model should be returned to the “drafting group” for further work. Toward the end of the same meeting, however, the Committee abruptly reversed course (on motion made by a member of the drafting group), directing that the Model should again be advanced to the Executive Committee.

<sup>2</sup> Because this submission focuses on flaws in the MTC’s development of the Model (and in the interest of brevity), the Trades’ will not here address those portions of the Staff Memo (on pages 10-16) relating to current law tools to address the MTC’s concerns and the Trades’ alternative proposed Model language.

It bears mention that the core membership of the drafting group from its inception (comprising a majority of this group) – regulators from CO, MA and MT – drafted the Model at the MTC, twice approved it (with no material changes), and have been among its most ardent advocates. It is to this drafting group that the Model has repeatedly been returned for further study (e.g., of retaliatory tax risks, insurance tax system burdens and effects, possible amendments to except traditional insurance company investments). And it is from this drafting group that the Model – essentially unchanged – has repeatedly been sent back up to the Uniformity Committee for adoption.

*It is not the purpose of affording pass-through entities tax-free status to permanently exempt the income itself from taxation. . . [I]f the ultimate recipient of the income is itself not subject to income tax, then the income will not be taxed at all. This was never the intent behind affording tax-free status to pass-through entities.*

The MTC cites no authority here (or elsewhere) for this broad (“This was never the intent. . .”) and foundational principle, which pervades the Staff Memo and the MTC’s rationale for the Model itself. In the absence of any such authority, it seems more plausible to conclude that policymakers provided pass-through entities with income tax-free status will full recognition of the facts that insurance companies (i) historically make substantial investments in partnerships and other such entities, and (ii) are subject to a special state tax system (premium and retaliatory taxation) that is imposed, because it yields far greater and more predictable revenue for the states, in lieu of income-based taxation.

*To the extent that insurance companies conduct non-insurance lines of business through pass-through entities, the income of those pass-through entities is currently not subject to tax at any point in time. . . . This creates a tax inequity between pass-through entities that engage in precisely the same lines of non-insurance business. . .*

The terms “non-insurance lines of business” and “non-insurance income,” as used here and throughout the discussion on pages 6-7 of the Staff Memo, have not been defined by the MTC.<sup>3</sup> Moreover, the Model itself neither distinguishes “non-insurance lines of business” from insurance lines of business nor defines these terms. Thus, the Model would impose the new tax without regard to whether an activity might be defined as an “insurance” or “non-insurance” activity.

Any effort to define the term “non-insurance lines of business” (not a term of art in the business, taxation or regulation of insurance) would seem to be uniquely within the province and expertise of the NAIC. The Trades are aware of no MTC outreach to the NAIC, which has participated in this process since July of last year, to seek to define this term.

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<sup>3</sup> The May 2011 “Report of the Hearing Officer” (page 7) states that “If an insurance company owns at least 50% of a non-insurance partnership or disregarded entity, it is more accurate to describe that business structure as allowing the insurance company to engage in two lines of business – insurance at the parent level and at least one non-insurance business at the lower tier levels.” It is not clear if this statement (not repeated in the Staff Memo) is intended to define the phrase “non-insurance lines of business” for purposes of the Model. If it is, the MTC has cited no authority or justification for redefining the insurance business in a way that is at variance with the way this business has heretofore been defined for all state regulatory (including tax) purposes.

The Trades dispute that “the income of those pass-through entities is currently not subject to tax at any point in time.” The current insurance tax system imposes a tax on the entirety of the insurance business (including underwriting and investment). The premium tax portion of this system is based on gross premiums receipts, rather than net income, but this does not detract from the well-established facts that this tax is on the privilege of conducting the entire insurance business in the states and imposes an exceedingly high tax burden relative to income-based taxes.

Lastly, if there is a “tax inequity” between insurance company investors and other corporate investors, the Trades question why not a single industry, other than the insurance industry (and REITs) has engaged with respect to the MTC’s development of the Model over the past four years.

#### **Staff Memo Page 6**

*The magnitude of the assets involved in these examples illustrate the central issue presented by use of a pass-through structure when the corporate parent is itself not subject to tax. . . In the specific context of insurance, it was never contemplated that the “in lieu of” premium tax would shield income of this magnitude from taxation at the pass-through level.*

Here again, no authority is cited to support the principle that “it was never contemplated” that constitutional and statutory “in lieu” provisions would preclude the imposition of income tax, on top of premium tax, on insurer investment income.

Contrary to the Staff Memo (and similar prior statements by MTC staff and drafting group members), neither the “magnitude of the assets” under management of the companies reflected in these examples nor other data produced by the drafting group reflects the “magnitude” of the income of such companies (or indeed, whether they have income at all).

#### **Staff Memo Footnote 3**

*. . . Bruce Johnson, a member of the MTC Executive Committee, expressed a willingness to consider a “rebuttable presumption” that would allow a pass-through, in an appropriate case, to demonstrate that the proposal ought not apply to it and invited industry to submit suggested language. To date, the Trades have not responded.*

Members of the MTC’s Executive Committee last year did express interest in identifying insurer investments that should be excepted from the reach of the Model. Such exceptions (e.g., for investments in real estate and claims handling and other traditional direct insurance business-related activities) also were discussed with the representatives of the NAIC and the Trades in a subsequent meeting of the drafting group. However, the discussion in the Staff Memo, the facts that the drafting group declined the offer of longtime Pennsylvania Deputy Commissioner Steve Johnson (at the end of his first and only meeting with this group) and the NAIC to provide further input, and the plain language

of the Model today, which remains largely unchanged from the Model considered by Executive in July 2011, appear to belie any interest of the drafting group in working to develop such exceptions.

#### **Staff Memo Page 7**

*The Trades maintain that it would be inequitable to impose state income tax on an LLC owned by an insurance company, because doing so would preclude an insurer from being able to offset its losses against LLC taxable income as insurers are generally not subject to state income tax.*

*The Trades' position inverts the basis upon which taxpayers are allowed to offset losses against income received by the taxpayer. If the model is adopted, it would be the LLC and not the insurer that would be the taxpayer. . . [T]he Trades objection is based on the fact that the LLC would not be allowed to offset its taxable income with a loss incurred by the nontaxable insurance company. This type of "loss offset" on income earned by the taxpayer that subsequently flows up to a nontaxpayer does not exist in state income tax law.*

The sole stated purpose of the Model is to achieve "tax equity" between corporate income taxpayers and insurance company premium taxpayers investing in "non-insurance lines of business." If the non-insurance investor corporation has losses, those losses can offset the tax liability of the pass-through entity where the investor is a non-insurance company, but not where it is an insurance company. If the pass-through entity has losses, those losses can offset the tax liability of the non-insurance company investor, but not the insurance company investor. The Staff Memo ignores the fact that the Model creates this new tax inequity between insurers and corporate income taxpayers, in direct contravention of its purported "tax equity" purpose.

*Having said that, there are loss scenarios under which the insurance company and its LLCs would benefit from losses under the proposal.*

*First, in years in which the LLC realizes a tax loss and the insurer realizes income, the LLC would pay no tax and the state could not offset the insurer's income against the LLC loss. . .*

Under the Model, there are no "scenarios" under which the insurance company (unlike a corporate income taxpayer) can possibly "benefit" from the losses of an LLC in which it invests. (There also are no scenarios under which the gains of such an LLC -- unlike a corporate income taxpayer's LLC -- can offset the losses of its premium taxpaying insurance company investor, a fact that is ignored in the Staff Memo.)

As to this first stated "benefit" to an insurance company, in any year in which the LLC realizes a tax loss and the investor realizes income, the investor's liability would be reduced by this loss where the investor is a non-insurance company, but not where the investor is an insurance company. Rather, an insurer-investor will pay premium tax with no offset for the LLC's loss.

*Second, to the extent the LLC's allowable losses in any one year are subject to a cap, ordinarily the LLC itself would be able to carry its unused losses forward to subsequent years in which it realizes income. In this situation, there is an offset against income, entirely at the LLC level.*

As to this second stated "benefit" to an insurance company, the loss carrying provisions are not available to premium taxpayer insurance companies.

*Third, if imposition of income tax at the LLC level would be at all relevant to the calculation of retaliatory tax, any year in which the LLC realizes a loss would reduce retaliatory tax below what it would be under current law.*

As to this last stated "benefit" to an insurance company, the foregoing statement appears to correctly recognize that the Model could have retaliatory tax implications, but misunderstands what those implications would be. Assume that a corporate income taxpayer and an insurance company each invest in a 50 percent interest in a LLC. When the LLC breaks-even, no tax is owed with respect to the LLC by the corporate income taxpayer or the insurer (with or without the Model). To the extent that the LLC has a loss, however, this loss reduces the corporate income taxpayer's tax liability, but reduces no tax owed – including retaliatory tax – by the insurer (with or without the Model). Again, a Model purportedly aimed solely at producing "tax equity" between income taxpayers and insurers investing in pass-through entities, creates new tax inequities between these two types of investors.

#### **Staff Memo Footnote 4**

*The Trades have consistently opposed imposing tax on the flow-through income received by the insurer. If the tax were imposed on the insurer, the insurance company would be able to offset its losses against the income received.*

There is no authority under current law or the Model to allow for an insurer's investment losses to offset premium tax liability. Furthermore, the Trades (and others) have consistently questioned the basic principles underpinning the Model, including the assumption that there is no added retaliatory tax exposure. Thus, the Model would impose tax at the pass-through entity level, rather than the insurance company level, not because the Trades have advocated this approach (as implied by the first sentence), but solely as the MTC drafting group's chosen device to avoid state retaliatory taxation.

#### **Staff Memo Page 8**

*The Trades have consistently maintained that imposing state income tax on LLCs owned by insurers could subject insurance companies to additional retaliatory tax in states that do not adopt the MTC proposal . . .*

*It is certainly not the intent of this project to subject insurers to additional retaliatory tax in any state. Where retaliatory tax is concerned, caution is particularly advisable because the states are free to impose retaliatory tax free of the restrictions ordinarily imposed on state taxation by the Commerce Clause. This makes prediction of the likely consequences of imposing income tax on an LLC owned by an insurer particularly difficult. The best that can be done is to make a reasonable assessment of the likelihood of this occurring. . .*

Absent here (and throughout the “Retaliatory Tax” discussion in the Staff Memo) is the fact that *all* outside input received by the MTC (Pennsylvania’s Deputy Commissioner Johnson (on behalf of the insurance regulatory community), the NAIC’s senior legal staff, Professor Pomp, and the major national trade associations of the life and property and casualty insurance industries), without exception, confirmed that the Model would trigger a real and substantial risk of retaliation under state insurance retaliatory tax statutes. In making its “prediction” and “reasonable assessment” of the retaliatory tax risk under the Model, the drafting group substitutes unsubstantiated speculation for this uniform expert input, and the Staff Memo relegates to a footnote (footnote 12) the fact that the NAIC has offered to survey its membership to provide some empirical basis for making this assessment. The Trades have repeatedly urged the MTC to accept this offer. Significantly, to the best of the Trades’ knowledge, the Uniformity Committee advanced the Model to the Executive Committee level (for a second time) without any MTC response to this NAIC offer.

#### **Staff Memo Pages 9-10**

*The Trades suggest that a tax [under the Model] could lead to retaliatory tax, because imposing such a tax would merely create a “legal fiction” to allow the states to impose tax on the investment income of insurance companies.*

*All businesses, in whatever form conducted, are legal fictions. This is true of a corporation as much as it is of a LLC.*

The Trades have questioned whether and why any state applying its tax law would respect a legal fiction (i.e., the Model’s shifting of tax to an otherwise non-taxable pass-through entity) concededly established for the sole and express purpose of avoiding such tax (i.e., to avoid the effects of state retaliatory tax statutes). This point, which has not been addressed by the MTC, has nothing to do with the legal fiction of organizing a business as a corporation or an LLC.

*Furthermore, the District of Columbia currently imposes income tax on pass-through entities themselves. There is every reason to believe that DC law **currently** applies to non-insurance LLCs in which an insurance company has less than 100% ownership. Apparently, there have been no adverse retaliatory tax consequences as a result...*

The Staff Memo seeks to make a point about retaliatory tax risk by using the example of the District of Columbia’s income tax. This example confuses a tax uniformly imposed on a pass-through entity, without regard to the identity of its corporate investor, with a tax that is imposed directly on such an entity only because its corporate investor is subject to a distinct state tax system; i.e., in effect, because

the investor is an insurance company. It is the latter tax (the NAIC, Professor Pomp and the Trades agree) that triggers the real and substantial risk of state retaliatory taxation.

Furthermore, retaliatory taxation only becomes an issue to the extent that a state has domestic insurers writing business in other states. The District of Columbia, not now a major center of the insurance industry, has been seeking to attract insurance industry jobs and investment. The District's adoption of the Model would serve as a powerful disincentive to its ability to meet this public policy goal since multi-state insurers choosing to domesticate in the District would potentially face retaliatory taxation of a portion of their investment income whenever they write business in other states.

#### **Staff Memo Page 10**

*In addition, the justification for requiring pass-throughs to pay income tax when owned by a non-taxable entity has nothing to do with the fact that the owner may be an insurer.*

This cannot be squared with the sole justification for shifting the tax from the investor to the otherwise non-taxable pass-through entity; the avoidance of insurance retaliatory taxation. Nor is this well-documented justification likely to be overlooked by states imposing retaliatory taxes on insurance companies domiciled in states that adopt the Model.

*The Trades position would completely hobble the states' sovereign right to adjust their tax laws in light of an ever evolving economy on the mere assertion that doing so might trigger retaliatory tax.*

Here again, all expert witnesses are in accord that the Model would trigger real and substantial risks of state retaliatory taxation (and other unintended consequences) and the MTC has ignored invitations by the NAIC (and industry) to collect empirical evidence on this question. The Trades agree that conclusions about the merits of the Model should not be based on "mere assertions," but that is what the drafting group now asks the MTC to do.

There is no basis for the broad assertion relating to states' rights to "adjust" their tax laws. The Model imposes a new, additional tax, outside of the current insurance tax system, on insurer investment income.

By extending the state corporate income tax system to insurer investment income (not part of the premium tax base), the MTC can only encourage policymakers and industry to reassess the equities of singling-out the insurance industry under current law for a tax burden that is recognized as being disproportionately high (in profitable and unprofitable times) relative to other industries. If there is a state "sovereign right" that stands to be hobbled here, it is the choice (knowingly made by nearly all states) of the current insurance tax system.<sup>4</sup>

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<sup>4</sup> As aptly stated in the Staff Memo (page 13) (albeit in the context of discussing the imposition on insurers of income *and* premium taxes) subjecting insurers to income taxation "would fundamentally change the way

### **Conclusion**

The Trades urge the MTC to terminate this ill-conceived project or, at a minimum, undertake the work needed to conclude it on a sound and supportable basis (in which case, the Trades continue to stand ready to assist the MTC in any way possible).

Respectfully submitted,

**American Council of Life Insurers**

**American Insurance Association**

**Property Casualty Insurers Association of America**

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insurance companies are generally taxed at the state level,” “negatively impact revenue derived from a totally different tax—the premium tax,” and “raise profound policy issues under a tax regime that is beyond the scope of the Multistate Tax Compact.”